



**Report of the Independent Expert on the transfer of the long-term business of  
London General Insurance Company Limited to London General Life Company  
Limited.**

Prepared by:

**Oliver Gillespie FIA**

## CONTENTS

<b>1. Introduction</b>	<b>3</b>
The Independent Expert	3
The scope of my report	3
Qualifications and disclosures	4
Limitations	4
Technical Actuarial Standards (“TAS”)	5
<b>2. General considerations of the Independent Expert</b>	<b>6</b>
Introduction	6
The structure of my report	6
Security of policyholder benefits	6
Treating customers fairly (“TCF”)	7
The current UK regulatory regime	7
The financial information in this report	9
Solvency II	9
<b>3. Background on companies concerned in the Scheme</b>	<b>11</b>
TWG Europe	11
LGI	11
LGL	11
LGI and LGL products	11
The risk profiles of LGI and LGL	12
Reinsurance between LGI and LGL	13
<b>4. The proposed Scheme</b>	<b>15</b>
Motivation for the Scheme	15
Summary of the Scheme	15
After the Scheme	16
<b>5. The effect of the Scheme on the holders of the transferring LGI policies</b>	<b>17</b>
Introduction	17
The financial strength available to support the transferring policies	17
The change in the risk profile to which the transferring policies will be exposed	19
Management and servicing of the transferring LGI policies	19
The benefit expectations under the transferring LGI policies	20
Conclusions for the holders of the transferring LGI policies	20
<b>6. The effect of the Scheme on the holders of non-transferring LGI policies</b>	<b>21</b>
Introduction	21
The financial strength of LGI	21
The change in the risk profile to which the non-transferring LGI policies will be exposed	21

---

Management and servicing of the non-transferring LGI policies .....	22
The benefit expectations under the non-transferring LGI policies .....	22
Conclusions for the holders of non-transferring LGI policies .....	22
<b>7. The effect of the Scheme on the holders of current LGL policies .....</b>	<b>23</b>
Introduction .....	23
The financial strength of LGL .....	23
The change in the risk profile to which the current LGL policies will be exposed .....	24
Management and servicing of the current LGL policies .....	24
The benefit expectations under the current LGL policies .....	24
Conclusions for the holders of current LGL policies .....	25
<b>8. Other considerations due to the Scheme .....</b>	<b>26</b>
Solvency II .....	26
The FSA waiver re communications to policyholders .....	26
Costs of the Scheme .....	26
Mis-selling risk .....	27
Tax .....	27
<b>9. Conclusions .....</b>	<b>28</b>
<b>Appendix 1 – Selected financial information as at 31<sup>st</sup> December 2010 .....</b>	<b>29</b>
<b>Appendix 2 – Pro forma financial position post-transfer as at 31<sup>st</sup> December 2010 .....</b>	<b>31</b>
<b>Appendix 3 – Key sources of data .....</b>	<b>33</b>
<b>Appendix 4 – Terms of reference .....</b>	<b>34</b>
<b>Appendix 5 – Statement of Independence .....</b>	<b>35</b>
<b>Appendix 6 – FSMA 2000 (regulated Activities) Order 2001 – selected paragraphs .....</b>	<b>36</b>

## 1. INTRODUCTION

### The Independent Expert

- 1.1. When an application is made to the High Court (“the Court”) for an order to sanction the transfer of long-term insurance or reinsurance business from one insurer to another, the application is subject to Part VII of the Financial Services and Markets Act 2000 (“FSMA”) and approval by the Court under Section 111. FSMA requires the application to be accompanied by a report on the terms of the Scheme by an Independent Expert.
- 1.2. I have been appointed by London General Insurance Company Limited (“LGI”) and London General Life Company Limited (“LGL”) to report, pursuant to Section 109 of FSMA, in the capacity of the Independent Expert, on the terms of the proposed scheme providing for the transfer of the long-term business of LGI to LGL. LGI will be responsible for the payment of fees incurred by me in my capacity as Independent Expert for the proposed scheme.
- 1.3. The purpose of this report is to review the proposed transfer of the long-term insurance business from LGI to LGL and, in particular, to consider the impact of the proposed transfer on the security of benefits and the benefit expectations of the existing long-term insurance policyholders of LGI and LGL.
- 1.4. In this report (“my report”) I refer to this proposed scheme as “the Scheme” or “this Scheme” and throughout the remainder of this report, these terms are used to cover all the proposals included in the scheme of transfer, including any documents referred to therein relating to the proposed implementation and operation of the scheme of transfer.
- 1.5. The Scheme will be presented to the Court for sanction under Section 111 of FSMA.

### The scope of my report

- 1.6. My terms of reference have been reviewed by the Financial Services Authority (“FSA”) and are set out in Appendix 4. My statement of independence (also reviewed by the FSA) is in Appendix 5.
- 1.7. My report has been prepared under the terms of the guidance set out in Chapter 18 of the Supervision Manual contained in the FSA Handbook.
- 1.8. My report considers the consequences of the Scheme for the policyholders of LGI and LGL.
- 1.9. In reporting on the Scheme as the Independent Expert, I recognise that I owe a duty to the Court to assist the Court on matters within my expertise. This duty overrides any obligation to LGI and LGL. I confirm that I have complied with this duty.
- 1.10. I am aware of the requirements regarding experts set out in Part 35 of the Civil Procedure Rules, this practice direction and the Protocol for Instruction of Experts to give Evidence in Civil Claims.
- 1.11. In assessing the impact of the Scheme on the policyholders of LGI and LGL, and whether those policyholders are being treated fairly as a result of the implementation of the Scheme, I have had regard to:
  - The effect of the Scheme on the security of policyholder benefits and on the expectations of policyholders created by past practices employed, or statements made, by each company;
  - Various discussions with, and figures provided by, the Actuarial Function Holder (“AFH”) of LGL (who has also been approved to fulfil the role of AFH for the long-term business in LGI); and
  - The witness statement of Kevin Kennedy, director of LGI and LGL.
- 1.12. As far as I am aware, there are no matters which I have not taken into account in undertaking my assessment of the Scheme and in preparing my report, but which nonetheless should be drawn to the attention of policyholders in their consideration of the terms of the Scheme.

- 1.13. I confirm that I have made clear which facts and matters referred to in this report are within my own knowledge and which are not. Those that are within my own knowledge I confirm to be true. The opinions I have expressed represent my true and complete professional opinions on the matters to which they refer.
- 1.14. My report does not consider alternative schemes.

### Qualifications and disclosures

- 1.15. I am a Fellow of the Institute and Faculty of Actuaries having qualified in 1999 and hold a certificate issued by the Institute and Faculty of Actuaries to act as a Life Actuary (including with-profits).
- 1.16. I am a Principal of Milliman Limited ("Milliman") and I am based in its UK life insurance practice. My experience in the UK life insurance industry includes a number of Actuarial Function Holder, Independent Expert, expert witness and reviewing actuary roles.
- 1.17. My appointment as the Independent Expert has been approved by the FSA in a letter dated 13 September 2010 to LGI.
- 1.18. I submitted a statement of independence to the FSA for review before my approval. This statement of independence is included in Appendix 5.

### Limitations

- 1.19. This report, and any extract or summary thereof has been prepared particularly for the use of the bodies or persons listed below:
- The Court;
  - The Directors and senior management of LGI;
  - The Directors and senior management of LGL;
  - The FSA or any other governmental department or agency having responsibility for the regulation of insurance companies in the UK; and
  - The professional advisors of any of the above.
- 1.20. In accordance with the legal requirements under FSMA, copies of my report may be made available to the policyholders of LGI and LGL and other interested parties.
- 1.21. In preparing my report, I have had access to certain documentary evidence provided by LGI and LGL, the key elements of which are listed in Appendix 3. I have also had access to, and discussions with, senior management of LGI and LGL. This has included, for both LGI and LGL the:
- Director of Underwriting;
  - Finance Director;
  - Company Secretary;
  - Legal Director; and
  - Chief Actuary and AFH.
- 1.22. In the rest of this report I refer to these collectively as "senior management" of LGI and LGL. This senior management team is responsible for both the day to day running and the long term strategic governance of LGI and LGL. Collectively and individually they have a substantial amount of knowledge and experience of LGI and LGL and have held FSA approved roles in the UK insurance industry for a considerable time. I am satisfied that it is appropriate to rely on their judgement and testament.

- 1.23. Much of the information listed in Appendix 3 has been subject to formal external audit and my conclusions depend on the substantial accuracy of this information without independent verification. I have considered, and am satisfied with, the reasonableness of this information based upon my own experience across the industry.
- 1.24. This report must be considered in its entirety as individual sections, if considered in isolation, may be misleading. Draft versions of this report should not be relied upon for any purpose. I have provided a summary of my report for inclusion in the policyholder circular (and, where relevant, distribution to any persons requesting a copy of it) and, other than this, no summary of my report may be made without my express consent.
- 1.25. This report has been prepared by me on an agreed basis for LGI and LGL in the context of the Scheme and must not be relied upon for any other purpose. No liability will be accepted by Milliman, or me, for any application of my report for a purpose for which it was not intended nor for the results of any misunderstanding by any user of any aspect of the report. In particular, no liability will be accepted by Milliman or me under the terms of the Contracts (Rights of Third Parties) Act 1999.
- 1.26. The use of Milliman's name, trademarks or service marks, or reference to Milliman directly or indirectly in any media release, public announcement or public disclosure, including in any promotional or marketing materials, customer lists, referral lists, websites or business presentations is not authorised without Milliman's prior written consent for each such use or release, which consent shall be given in Milliman's sole discretion.

#### **Technical Actuarial Standards ("TAS")**

- 1.27. The following TAS apply to this report:
  - TAS (R) – Reporting Actuarial Information
  - TAS (D) – Data
  - Insurance TAS; and
  - Transformations TAS (all principles applied).
- 1.28. This report complies with all the TAS listed above.

## 2. GENERAL CONSIDERATIONS OF THE INDEPENDENT EXPERT

### Introduction

- 2.1. I have compiled my report in accordance with Chapter 18 of the Supervision Manual of the FSA Handbook.
- 2.2. Under FSMA, the concept of treating customers fairly (“TCF”) should be applied. To ensure that customers are treated fairly in the future, it is necessary to establish the ways in which customers have been treated in the past. From the policyholders’ perspective, the successful implementation of the Scheme must be on the basis that their benefits and fair treatment are not materially adversely affected.
- 2.3. I need to consider the terms of the Scheme generally and how the different groups of policyholders are likely to be affected by the Scheme and, in particular:
- The effect of the Scheme on the security of the policyholders’ contractual rights, including the likelihood and potential effects of the insolvency of the insurer; and
  - The likely effects of the Scheme on the benefit expectations of policyholders.
- 2.4. As described in Section 3 of this report, two insurance companies are involved in the Scheme, each with a different mix of business.
- 2.5. The type of policy held by a policyholder will be a key determinant of the risks to which the policyholder is exposed. Other than this, the key determinants will be the characteristics of the company in which the policy is held – for example:
- Size of company;
  - Amount of capital held, other calls on that capital and capital support currently available to the company;
  - Investment strategy;
  - Mix of business written;
  - Company strategy – e.g. open or closed to new business, acquisitions strategy; and
  - Operational risks, reinsurance, governance, and tax.
- 2.6. Some of these risks are company specific, for example risks arising from the particular mix of business written or the company strategy, and some are risks that are common to various different groups of policyholders across the companies subject to the Scheme.

### The structure of my report

- 2.7. Section 3 of this report provides some background to LGI and LGL.
- 2.8. Section 4 summarises the key aspects of the Scheme.
- 2.9. In Sections 5, 6 and 7, I consider the issues arising from the Scheme in relation to the policyholders of LGI holding policies that will be transferred under the Scheme, and the existing policyholders of LGI and LGL respectively.
- 2.10. Section 8 covers some further aspects of the Scheme and my conclusions are in Section 9.

### Security of policyholder benefits

- 2.11. As part of my role as Independent Expert for the Scheme, I need to consider the security of policyholder benefits, that is the likelihood that policyholders will receive their guaranteed benefits when these are due.

- 2.12. In considering and commenting upon policyholder security, I shall consider primarily policyholders' guaranteed benefits and as appropriate their reasonable benefit expectations. The amount by which the long-term insurance fund assets exceed the long-term insurance fund liabilities (including the mathematical reserves) provides security for guaranteed benefits. Security is also provided by the margins for prudence in the assumptions used to calculate the long-term business fund liabilities and by the available capital in the shareholder fund.

### Treating customers fairly ("TCF")

- 2.13. As Independent Expert for the Scheme, I need also to consider the proposals in the context of the FSA's TCF regime and in particular the effect on policyholders' benefit expectations.
- 2.14. This involves consideration of areas where discretion is involved on behalf of the relevant insurance company with regard to the charges applied to a policy and the benefits granted to the policyholder (not relevant to LGI and LGL), and also to the management, service and governance standards applied.

### The current UK regulatory regime

#### Classification of business

- 2.15. In 2001, FSMA was updated by an order called The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 ("the Order" or "this Order"). This Order is currently in force and therefore currently applicable to UK insurance business.
- 2.16. Schedule 1 of the Order sets out various definitions for contracts of insurance – part 1 of Schedule 1 defines general insurance contracts and part 2 defines long-term insurance contracts.
- 2.17. In particular, Schedule 1 of the Order defines accident and sickness business as general insurance and permanent health business as long-term insurance. The definitions given are summarised below:

*Accident insurance: Provides fixed benefits or indemnification (or a combination of these) against the risks of the insured:*

- Sustaining an injury as the result of an accident;
- Dying as a result of an accident; or
- Becoming incapacitated due to a disease.

*Sickness insurance: Provides fixed benefits or indemnification (or a combination of these) against the risks of loss to the insured persons due to sickness or infirmity.*

*Permanent Health Insurance: Provides specified benefits against the risks of the insured becoming incapacitated in consequence of sustaining injury as a result of an accident, sickness or infirmity and are in effect, from outset, for a term of 5 years or more.*

*Also, the policy is not cancellable at the discretion of the insurer.*

- 2.18. The full text of these definitions is given in Appendix 6.
- 2.19. The key points to note at this time are:
- A contract can only be in one class – for example a contract cannot be both general insurance and long-term business nor cannot it be both sickness insurance and permanent health insurance.
  - An original term of five years or more (and the contract is not cancellable by the insurer) categorises a contract as long-term business.

## The current UK regulatory financial reporting regime

2.20. At the 2004 year end the FSA introduced a risk based capital framework under which companies are required to assess solvency under two regimes called Pillar I and Pillar II.

### *Pillar I*

2.21. Under Pillar I, assets are, broadly speaking, valued at market value and are subject to various admissibility criteria. Reserves for long-term non-profit policies are calculated on a single basis which includes margins for prudence.

2.22. Under Pillar I, reserves for general insurance business are calculated as the sum of the following:

- The unearned premium reserve (“UPR”) – the UPR is the amount set aside from premiums written before the valuation date to cover risks incurred after that date;
- The additional amount for unexpired risk (“URR”) – the URR is the amount held in excess of the UPR, to allow for any expectation that the UPR will be insufficient as at the valuation date to cover the cost of claims and expenses incurred during the period of unexpired risk; and
- The claims outstanding provision – the reserve set up in respect of the liability for all outstanding claims at the valuation date, whether reported or not.

2.23. The UPR is typically calculated on a pro-rata (daily) basis (but alternative methods may be acceptable where the daily basis is not appropriate) and makes no allowance for the time value of money (i.e. discounting).

2.24. The claims outstanding provision is typically made-up of the case reserves *plus* the amount, if any, for claims incurred but not reported (“IBNR”) at the valuation date. Case reserves are the amounts estimated on a case-by-case basis to settle reported (open) claims. The IBNR reserve is the amount estimated (typically using statistical techniques) to provide for claims in respect of claim events that have occurred before the valuation date, but had still to be reported to the insurer by that date.

2.25. Under UK regulatory practices, the claims outstanding provision estimate cannot include any allowance for the time value of money (i.e. discounting). Therefore, all other things being equal, a margin exists in the provision to cover (at least in part) adverse claims development. (It should be noted that there are some limited circumstances under UK regulations where the claims outstanding provision may be discounted for the time value of money.)

2.26. In addition to holding these reserves to cover future liabilities, companies must hold further amounts of capital to cover themselves against adverse deviations in future experience and one-off shocks to investment performance. The overall capital requirement under the Pillar I regime is called the Capital Resources Requirement (“CRR”). Firms writing long-term insurance business and general insurance business must calculate and hold a CRR in respect of both types of insurance business. The CRRs in respect of long-term insurance business and general insurance business are each subject to a minimum of the Base Capital Resources Requirement (“BCRR”) (€3.5 million or £3.04 million as at 31 December 2010).

### *Pillar II*

2.27. The capital that must be held under Pillar II is an amount set by the Individual Capital Assessment (“ICA”), which is the company’s own assessment of its capital requirements. Pillar II is intended to provide a more realistic and complete view of the risks to which the company is exposed and to provide a framework within which the company should be managed.

2.28. The FSA requires firms, when preparing their ICA, to identify the major risks they face and, where capital is appropriate to mitigate those risks, to quantify how much (and what type) of capital is appropriate. The ICA is a complicated process which relies on an assessment of the risks in the business, extensive modelling and management judgement.

- 2.29. The FSA expects firms to conduct stress tests and scenario analyses in respect of each risk. The capital requirements so determined are then aggregated allowing for diversification between risks where appropriate. These stress tests and scenario analyses, together with the supporting analysis, should be documented and, along with the results, submitted to the FSA (on request) as the ICA. The company is not required to publish its Pillar II capital requirement.
- 2.30. The FSA will review the ICA periodically and may prescribe an additional amount of capital that must be held by the firm in addition to the ICA. The total amount of Pillar II capital prescribed by the FSA is usually expressed as a percentage of the ICA capital, and is called Individual Capital Guidance ("ICG").
- 2.31. For the ICA, a firm will assess the amount of capital it needs to hold to remain able to meet its liabilities as they fall due in all but the most extreme circumstances. The FSA has indicated that ICG will be given taking into consideration capital resources consistent with a 99.5% confidence level that the firm will be able to meet its liabilities over a one year timeframe or, if appropriate to the firm's business, an equivalent lower confidence level over a longer timeframe.
- 2.32. This ICG sets out the results of the FSA's review of the ICA and the minimum level of capital that it would expect the company to hold based on its view of the ICA and the risk management framework of the company. The ICG is intended to target the same level of confidence as described above for the ICA, but it represents the FSA's view rather than that of the company.

### The financial information in this report

- 2.33. The Pillar I balance sheets shown in Appendix 1 are based on the FSA Returns as at 31<sup>st</sup> December 2010 which have been published, externally audited and signed off by the Board.
- 2.34. For LGL the 31<sup>st</sup> December 2010 balance sheet has been adjusted to allow for the payment of a dividend to shareholders of £5 million. I understand that the Board intends to transfer this money out of LGL prior to the implementation of the Scheme and so it is appropriate to treat this payment as having been made in the LGL balance sheet when considering the transfer.
- 2.35. For LGI the 31<sup>st</sup> December 2010 balance sheet has been adjusted to allow for an extra one-off business provision of £3.1 million. The provision is in respect of amounts ultimately payable in euro and so the amount in sterling will fluctuate as currency exchange rates fluctuate – the £3.1 million is calculated using the exchange rate as at 31<sup>st</sup> December 2010.
- 2.36. At the time of writing this report, the Pillar II capital requirements for 2010 have not been finalised. My comments in this report with respect to Pillar II capital requirements are based on the Board approved Pillar II results as at 31<sup>st</sup> December 2009, adjusted to take account of the FSA's ICG (as previously issued).
- 2.37. As stated above, detailed Pillar II financial information is not published and remains private between the FSA and the company. I have therefore not included any Pillar II figures in this report.

### Solvency II

- 2.38. The regulatory solvency reporting requirements for European Union ("EU") insurers and reinsurers are due to undergo a major overhaul. The start date for the implementation of this new regime was set as the start of 2013 but recent communications from the EU Council appear to suggest that this will be changed. This new regime is called Solvency II and aims to introduce solvency requirements that better reflect the risks that insurers and reinsurers actually face and to introduce consistency across the EU. UK companies will be required to adhere to a set of new, risk based capital requirements and, in contrast to the position under the current UK Pillar II requirements, the results will be shared with the public.
- 2.39. In order to allow companies, supervisors and the European Commission to consider the likely effects of the new regime on insurers and reinsurers, the industry has undertaken a number of trial runs, called "Quantitative Impact Studies" ("QIS") and produced results under the Solvency II rules as they have developed. The most recent of these, QIS 5, was completed in November 2010.

- 2.40. The basis for the Solvency II calculations has not yet been finalised. I have discussed, at a high level, the likely impact of the Scheme on a Solvency II basis with the senior management of LGI and LGL. Although the introduction of the Solvency II regime may affect the capital that would be required by LGI and LGL, it seems unlikely that the effects of the Scheme on these capital requirements will be materially different to the effects of the Scheme on the current Pillar II capital requirements.
- 2.41. I consider the risks around Solvency II in respect of the transfer in section 8 of this report.

### 3. BACKGROUND ON COMPANIES CONCERNED IN THE SCHEME

#### TWG Europe

- 3.1. Both LGI and LGL are wholly-owned direct subsidiaries of TWG Europe Limited, a company incorporated in England and Wales. TWG Europe Limited is not authorised by the FSA. Their ultimate parent company is Onex Corporation, a Canadian corporation.

#### LGI

- 3.2. LGI was incorporated in England and Wales on 22 November 1984. LGI is authorised by the FSA to underwrite general insurance business falling within classes 1, 2, 9, 13 and 16 of Schedule 1, Part I of the Order.

#### LGL

- 3.3. LGL was incorporated in England and Wales on 16 November 1989. LGL is authorised by the FSA to underwrite long-term insurance business in classes I, III and IV of Schedule 1, Part II of the Order.

#### LGI and LGL products

##### *Summary*

- 3.4. LGI and LGL underwrite payment protection insurance for customers who take out loans or other credit finance from banks and other lenders.
- 3.5. LGI also underwrites extended warranty insurance for domestic electrical goods and motor vehicles, property insurance and related ancillary coverages, but such insurance is not the subject of this Scheme.
- 3.6. LGI and LGL's payment protection insurance normally provides one or more of the following covers:
- Life;
  - Critical illness;
  - Accident and sickness (sometimes referred to as disability cover);
  - Hospitalisation benefit; and
  - Unemployment benefit.
- 3.7. These coverages can be considered policies which collectively form the wider payment protection insurance contract. In this report I use "policy" or "coverage" to refer to these coverages, and "contract" to refer to the overall payment protection insurance contract.
- 3.8. The life cover has been underwritten by LGL.
- 3.9. The accident, sickness, critical illness, and hospitalisation coverages/policies have typically been underwritten by LGI if the term at outset has been less than or equal to 5 years, and underwritten by LGL if the term is longer than 5 years. Unemployment cover has been underwritten by LGI.

##### *Contract details*

- 3.10. The customer is issued with a single contract and a single contract number. The contract documents contain terms and conditions for each of the insurance covers and states which company is providing which type of cover. For example, the section of the policy setting out the terms and conditions for the life cover will state that

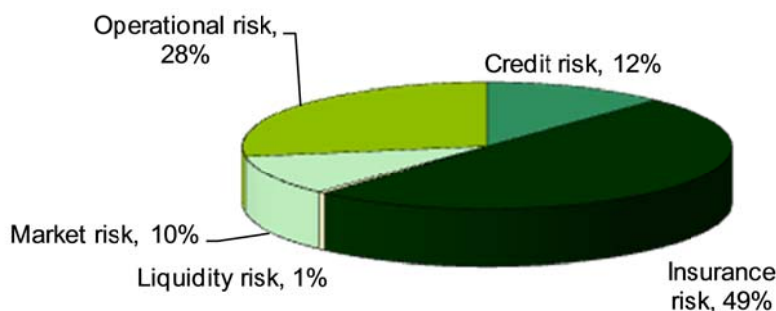
the life cover is provided by LGL and the section setting out the terms and conditions for the unemployment cover will state that this cover is being provided by LGI.

- 3.11. The payment protection insurance contracts are designed to assist the policyholder to continue making repayments under the loan/credit agreement if one of the insured events occurs. The term of the insurance contract normally coincides with the term of the underlying loan/credit agreement which it is intended to protect.
- 3.12. Prior to 29<sup>th</sup> May 2009 the contracts were generally issued as single premium contracts, whereby the policyholder paid a single premium when taking out the contract for cover throughout the contract term, with no further premium payable.
- 3.13. On 29<sup>th</sup> May 2009 the FSA banned the sale of single premium payment protection contracts. Therefore, since this date, all contracts issued in the UK have been issued as regular premium contracts.

### The risk profiles of LGI and LGL

#### *LGI*

- 3.14. A summary of the key risk exposures for LGI, based on the ICA capital (gross of reinsurance and before diversification and grossing up for tax) as at 31<sup>st</sup> December 2009 is shown below.

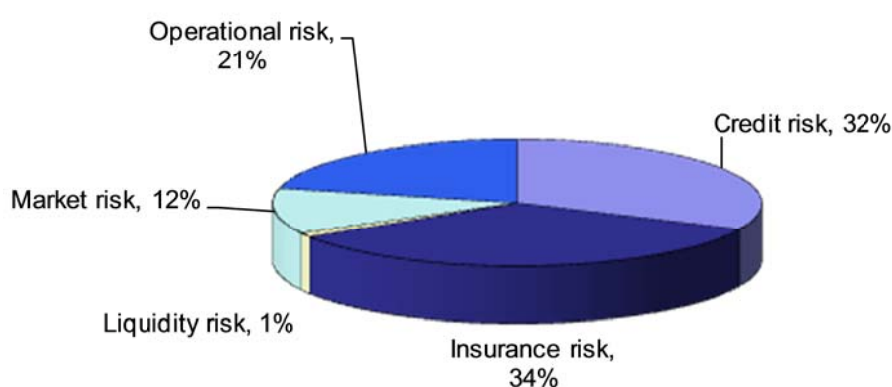


- 3.15. The principal risk for LGI is insurance risk, which predominantly takes the form of a risk of a potential increase in the cost of:
- Unemployment claims;
  - Motor warranty claims;
  - Accident and sickness claims; and
  - Appliance and technology warranty claims.
- 3.16. The second biggest risk is operational risk, which is mainly the risk of a reinsurance dispute, a change in the FSCS levy rate and a tax reporting failure.

- 3.17. This is followed by credit risk, which arises from exposure to the potential default of debtors, reinsurers and corporate bond investments.
- 3.18. LGI is also exposed to market risk. This is primarily driven by the potential increase in interest rates, which would result in a greater fall in asset values relative to the fall in liability values.

### LGL

- 3.19. A summary of the key risks exposures for LGL, based on the ICA (gross of reinsurance and before diversification and grossing up for tax) as at 31<sup>st</sup> December 2009 is shown below.



- 3.20. The principal risk for LGL is insurance risk, predominantly due to exposure to increased claims in the event of a mortality pandemic.
- 3.21. Credit risk is also a major risk, which is driven by the potential default of debtors and reinsurers. Reinsurance is placed with reinsurance companies (typically A rated) and captive reinsurance companies (typically unrated but backed with a suitable security such as a letter of credit from a highly rated institution).
- 3.22. The market risk is primarily driven by the potential increase in interest rates, which would result in a greater fall in asset values relative to the fall in liability values.

### Reinsurance between LGI and LGL

- 3.23. On 24<sup>th</sup> December 2010, a reinsurance treaty between LGI and LGL was brought into effect, with an effective date of 1<sup>st</sup> January 2010.
- 3.24. Under the treaty the policies of LGI deemed to have had a term at outset of 5 years or more, and that are part of non-cancellable (by LGI) payment protection contracts, are wholly reinsured to LGL. LGI is therefore a creditor of LGL and, as accepted reinsurance business, liabilities under this treaty rank below the direct LGL policyholders as creditors of LGL in the event of the wind-up of LGL.

- 3.25. From the point of view of the affected policyholders, their policy remains with LGI, they receive communications from LGI and they rely on LGI to honour the terms and conditions of the policy and to pay the benefits due under the policy.

## 4. THE PROPOSED SCHEME

### Motivation for the Scheme

- 4.1. As a result of a review of the insurance contracts written by LGI and LGL, senior management of LGI and LGL became concerned as to the classification of some of the accident, sickness, hospitalisation and critical illness policies contained within some of the payment protection contracts that had been written in LGI.
- 4.2. In the course of the review it was discovered that for some of the payment protection contracts containing these types of cover:
- The underlying loan/credit agreements have an original term of 5 years or more; and
  - The contract is non-cancellable by LGI – that is the contract contains no right for LGI to cancel the cover prior to the end of the term.
- 4.3. Policies providing cover for accident, sickness, hospitalisation and critical illness within payment protection contracts meeting these criteria should correctly have been classified as long-term insurance contracts. As these policies had been written in LGI, which, as discussed in Section 3, is authorised to write short-term business only, senior management notified the FSA and obtained external legal advice.
- 4.4. As a result of these discussions and of further analysis by the senior management of LGI and LGL, the decision has been taken, with the approval of the FSA, to transfer the appropriate accident, sickness, hospitalisation and critical illness policies from LGI to LGL.

### Summary of the Scheme

- 4.5. The Scheme is scheduled to be presented to the High Court in the fourth quarter of 2011 (at the time of writing, the date is still to be fixed). If it is approved by the High Court, then on the “Effective Date”, the long-term business of LGI, together with all attaching obligations will transfer to LGL.
- 4.6. The transferring policies of LGI are those elements of the cover which are correctly classified as long-term insurance and are provided under payment protection insurance contracts which have a term at outset of 5 years or more and which are not cancellable by the insurer. All of the transferring policies have been issued by intermediaries in the UK and the Republic of Ireland.
- 4.7. The transferring policies provide one or more of the following types of cover: critical illness, accident, sickness and hospitalisation.
- 4.8. As at 31<sup>st</sup> March 2011, a total of 23,840 LGI contracts have been identified as including long-term insurance policies and these long-term insurance policies will be transferred under the Scheme to LGL. This total is made up of 5,399 from the UK and 18,081 from the Republic of Ireland.
- 4.9. Where other insurance covers (not constituting long-term insurance) are included in the wider payment protection contracts, these other covers will remain in place and will remain in LGI unless they too are classified as long-term business and therefore are included in the transferring policies.

### Cost of the Scheme

- 4.10. The cost of the Scheme will be borne by the shareholders of LGI.

### Transferring assets and liabilities

- 4.11. As described in Section 3, there is currently a reinsurance treaty in place under which the transferring policies of LGI have been wholly reinsured across to LGL. Therefore, the liabilities and mathematical reserves associated with the transferring policies currently reside in LGL.

- 4.12. Assets to cover the regulatory capital requirements with respect to the transferring LGI business are also currently held in LGL. LGI holds assets to cover the residual capital requirements with respect to reinsured business.
- 4.13. On the Effective Date all liabilities and obligations attributable to the transferring business will be transferred from LGI to LGL.
- 4.14. The value of assets to be transferred will be set as the mathematical reserves held in respect of the transferring business. These reserves were held in LGI but, since the inception of the reinsurance treaty, have been held in LGL.
- 4.15. Therefore, no actual assets will be transferred as assets corresponding to the transferring liabilities are those already transferred under the reinsurance treaty.

#### **Administration**

- 4.16. There will be no change to the administration of the transferring LGI policies and LGL policies after the transfer.
- 4.17. Direct debit mandates, standing orders etc. for the transferring policies will, after the Effective Date, remain payable to TWG Services Limited. There will be no changes to direct debit mandates or standing orders.
- 4.18. The Scheme will have no effect on the amounts charged to policyholders of the transferring policies.

#### **Reinsurance arrangements**

- 4.19. Outwards reinsurance treaties currently have both LGI and LGL listed as the cedant and do not discern in their construction precisely which reinsured benefits are originally covered by which of the ceding companies. Therefore these outwards reinsurance arrangements will remain unchanged and unaffected by the Scheme.

#### **After the Scheme**

- 4.20. After the implementation of the proposed Scheme:
- The transferred policies will be the responsibility of LGL;
  - Claims currently being processed or paid by LGI in respect of the transferring policies will be processed or paid by LGL;
  - All future claims in respect of the transferring policies will be dealt with by LGL;
  - LGI will continue as an authorised general insurance company;
  - LGL will continue as an authorised long-term insurance company; and
  - The reinsurance treaty between LGI and LGL in respect of the transferring LGI policies will be cancelled.

## 5. THE EFFECT OF THE SCHEME ON THE HOLDERS OF THE TRANSFERRING LGI POLICIES

### Introduction

- 5.1. In this section I consider the effect of the Scheme on the holders of the transferring LGI policies. As described in Section 3, LGI currently has both long-term and short-term policies and, under the Scheme, the long-term policies of LGI will be transferred to LGL. I consider the likely effects of the Scheme on the security of the guaranteed benefits under these policies and, where relevant, on the benefit expectations of the policyholders concerned.
- 5.2. The LGI long-term policies consist of accident and sickness policies within payment protection insurance contracts linked to:
- Personal loans made in the Republic of Ireland by Allied Irish Bank ("AIB") or Lombard.
  - Car financing products sold in the UK (e.g. Carcraft, Honda, Peugeot, Toyota); and
  - Personal loans made in the UK through First Trust Bank (part of the AIB Group).
- 5.3. As described in Section 4, under the Scheme these long-term policies of LGI will be transferred to LGL. Therefore, the key issues to consider are:
- The financial strength available to support the transferring LGI policies after the implementation of the Scheme;
  - Any changes to the profile of risks to which the transferring LGI policies are exposed; and
  - Any changes to the management of the LGI long-term business.
- 5.4. Prior to the reinsurance treaty being in force, LGI held financial resources in respect of the transferring policies in accordance with general insurance reserving regulations. Under the reinsurance treaty LGI has transferred reserves in respect of these transferring policies to LGL, but maintains capital requirements in accordance with the reinsurance of this business to LGL.
- 5.5. Section 2 of this report sets out a summary of the differences in respect of statutory reserving practices for long-term and short-term policies under current UK regulations. For the transferring LGI policies, the reserve currently held in LGL under the reinsurance treaty is set to be the higher of: the reserve as calculated on the general insurance basis used by LGI (UPR plus outstanding claims provision); and, the long-term insurance provision as calculated in accordance with the current LGL long-term insurance basis.
- 5.6. After the transfer LGL will hold reserves and capital resources in respect of these policies in accordance with its status as a long-term insurance company.

### The financial strength available to support the transferring policies

- 5.7. Currently, the transferring policies of LGI are reinsured to LGL. Therefore, prior to the Scheme, in respect of these policies:
- LGL holds the assets in respect of these policies;
  - LGL holds reserves in respect of these policies;
  - LGL has a liability to LGI in respect of the benefits under these policies; and
  - LGI has a liability to the policyholders in respect of their benefits under these transferring policies.
- 5.8. LGI policyholders will receive their benefits when due as long as LGI is able to pay them (taking account of any reinsurance recoverables). The financial strength of LGL is of secondary importance since, in the extreme

scenario of LGL becoming insolvent, these reinsured policyholders will still receive their benefits when due as long as LGI remains sufficiently financially strong – i.e. has sufficient resources to pay them.

- 5.9. As shown in Appendix 1, as at the end of 2010, LGI has assets in excess of the CRR of over £60 million. This represents over 10 times the reserves for the transferring LGI business. Therefore, even in the extreme scenario of 0% recovery under the reinsurance treaty, LGI has more than 10 times the necessary assets to cover the reserves of the transferring LGI business. Obviously, in such an extreme scenario it is likely that LGI will also have suffered some dilution of its capital resources, but 10 times the required assets provides significant security for the policyholder benefits.
- 5.10. Therefore, currently, the security of the benefits of the transferring LGI business depends primarily on the financial strength of LGI. The effect of LGL on this security is as a counterparty to a contract with LGI.
- 5.11. Table 3 in Appendix 1 shows that, as at 31<sup>st</sup> December 2010, on a Pillar I basis, LGI is currently financially strong with excess assets at 22% of total Pillar I liabilities and providing coverage for the Pillar I CRR of 277%.
- 5.12. After the Scheme has been implemented, the transferring LGI policies will derive their security from LGL. Table 3 in Appendix 2 shows that, based on figures as at 31<sup>st</sup> December 2010, if the Scheme had been implemented on that date, it is projected that LGL would have had excess assets of 53% of total Pillar I liabilities and coverage of its CRR of 191%.
- 5.13. These financial statistics show that, for the transferring LGI business:
- The ratio of excess assets to liabilities is expected to be greater in LGL after the Scheme than in LGI before the Scheme; and
  - The excess assets coverage for the CRR in LGL is projected to be lower after the transfer than in LGI prior to the transfer, but the projected coverage of 191% after the Scheme remains strong.
- 5.14. The tables in Appendices 1 and 2 show that the absolute amount of excess capital (before and after the CRR) is projected to be lower in LGL after the transfer than is currently the case in LGI. To a large extent this reflects the significantly larger volume of business in LGI and it should be noted that capital in excess of the regulatory capital requirements can, subject to certain logistical requirements, usually be transferred out to the shareholder.
- 5.15. LGL is projected to have £5.7 million of excess capital (after the CRR) after the transfer and, whilst less than the £60.4 million in LGI (prior to the transfer), this is still, in providing coverage of 191% of the CRR, a sign of financial strength.
- 5.16. It should also be noted that, the LGL business is fairly stable, has in the past generated healthy surpluses, and is expected to continue to generate surpluses in the future. Therefore, all else being equal, the CRR coverage percentage (currently 191%) would be expected to rise over time.
- 5.17. The future financial strength on which the transferring policies can rely for security will depend upon the capital management policy of LGL. This is currently the same as the LGI capital management policy.
- 5.18. The current capital policies have been discussed with the FSA and the Scheme will not lead to an immediate change to the capital management policies of either LGI or LGL. Moreover, I am satisfied that the implementation of Scheme will not have a material effect on the likelihood of the capital management policies changing in the future. The effects of any future changes to the capital management policy would need to be discussed with the FSA in advance of their implementation.
- 5.19. I am satisfied that the Scheme will not lead to a material change to the security of the guaranteed benefits under the transferring policies as derived from the capital management policies.
- 5.20. I am therefore satisfied overall that the proposed Scheme will not have a material adverse effect on the financial strength available to provide security for the benefits under the transferring LGI policies.

### The change in the risk profile to which the transferring policies will be exposed

- 5.21. As described above, the transferring policies (as policies of LGI) are currently primarily exposed to the risks of LGI. As described in Section 3, LGI has written a variety of short-term, general insurance products such as payment protection insurance and domestic appliance and motor extended warranty business.
- 5.22. The financial strength of LGI depends, in part, on the performance of the reinsurance treaty with LGL so the risk profile of LGI, and hence of the transferring policyholders, includes some exposure to the risks of LGL, albeit indirectly.
- 5.23. After the Scheme, these policies will be in LGL which has written long-term payment protection business such as life cover and critical illness cover.
- 5.24. There are therefore some key differences between the two companies which will directly affect the risk exposures of the transferring business, such as:
- The different sizes of the two companies;
  - The different products written by the two companies;
  - The different markets in which they compete; and
  - The underlying groups of policyholders which have different demographics, as the two companies have sold business to different groups of policyholders, through different channels, and in different geographical locations.
- 5.25. Therefore, the implementation of the Scheme will expose the holders of the transferring LGI policies to different types of risks and to different levels of risk.
- 5.26. In Section 2 of this report I set out a brief overview of the current UK regulatory regime in respect of capital requirements and solvency reporting. Both the Pillar I and Pillar II figures, to differing degrees, take account of the company's risk exposures. The Pillar I figures portray the coverage for the security of the guaranteed benefits and the Pillar II figures portray the company's ability to withstand extreme events. Based on the figures that I have seen, after the Scheme the transferring LGI business will be more than adequately capitalised on both a Pillar I and a Pillar II basis.
- 5.27. Therefore, although the Scheme will lead to a change in the risk profile and in the range of risks to which the transferring LGI business is exposed, I am satisfied that there will not be a material adverse effect on the security of the policyholder benefits of the transferring LGI policies.

### Management and servicing of the transferring LGI policies

- 5.28. The Scheme will lead to no change to:
- The managers or administrators of the LGI policies;
  - The terms and conditions of the policies (with the exception of minor changes to certain communications to reflect the fact that the policies are now policies of LGL and not LGI); or
  - The process by which charges to the policies are set.
- 5.29. Therefore, I am satisfied that the Scheme will not lead to any material changes to the management of the transferring LGI policies or to the benefits received by the transferring LGI policyholders.
- 5.30. There will be no change to the administration or service standards of the transferring policies, as transferring policies will continue to be serviced from the same systems.

### **The benefit expectations under the transferring LGI policies**

- 5.31. As discussed above, I am satisfied that:
- The transfer will not lead to a material deterioration in the security of the guaranteed benefits of the transferring policies;
  - The Scheme will lead to no change to the administration and service standards received under the transferring policies; and
  - The Scheme will not lead to any change to the management of the transferring policies.
- 5.32. After the transfer, the LGL Board will be responsible for the governance of the transferring LGI policies rather than the LGI Board as currently. The LGL Board currently carries out this governance role for similar long-term insurance business and so is aware of the issues affecting the transferring policies. The LGI and LGL Boards have the same members. I am satisfied that the Scheme will not have a material effect on the governance applicable to the transferring policies.
- 5.33. Therefore, I am satisfied that the Scheme will not have a material adverse effect on the benefit expectations of the holders of the transferring LGI policies.

### **Conclusions for the holders of the transferring LGI policies**

- 5.34. I am satisfied that the Scheme will not have a material adverse effect on:
- The security of benefits under the transferring policies of LGI;
  - The benefit expectations under the transferring policies of LGI; or
  - The service standards, management and governance received by the transferring policies of LGI.

## 6. THE EFFECT OF THE SCHEME ON THE HOLDERS OF NON-TRANSFERRING LGI POLICIES

### Introduction

- 6.1. In this section I consider the effect of the Scheme on the holders of non-transferring LGI policies. As described in Section 3, LGI currently has both long-term and short-term policies.
- 6.2. As described in Section 4, under the Scheme, the long-term policies of LGI will be transferred to LGL. Therefore, the key issues to consider for the non-transferring LGI policyholders are:
- The financial strength available to support the LGI policies after the implementation of the Scheme;
  - The changed profile of risks to which the non-transferring LGI policies will be exposed; and
  - Any changes to the management of the LGI short-term business.
- 6.3. Currently LGI holds financial resources in respect of the short-term policies and the long-term transferring policies (with appropriate allowance for the reinsurance treaty with LGL).

### The financial strength of LGI

- 6.4. Under the Scheme the long-term policies of LGI will be transferred to LGL.
- 6.5. Comparison of the tables in Appendices 1 and 2 shows the projected effect of the transfer on LGI on a Pillar I basis.
- 6.6. The amount of business being transferred is, at approximately 1% (by statutory reserve as at 31<sup>st</sup> December 2010), small in the context of LGI and, due to the reinsurance treaty brought into effect on 24<sup>th</sup> December 2010, the assets and liabilities in respect of the transferred business have already been transferred to LGL. The only financial effect of the transfer for LGI is therefore the release of the capital requirements in respect of the reinsured business. As the tables in the Appendices show, the Scheme is projected to have a small effect on the financial strength of LGI. In particular:
- The excess assets as a percentage of total assets is projected to remain constant at 22%;
  - The CRR coverage is projected to increase from 277% to 304%; and
  - The absolute amount of excess capital after the CRR is projected to increase by about 5%.
- 6.7. The future financial strength providing security for the LGI policies will depend upon the capital management policy of LGI.
- 6.8. The current capital policy has been discussed with the FSA and the Scheme will not change the current capital policy. I am therefore satisfied that the Scheme will not affect the security derived by the LGI policies from the capital management policy.
- 6.9. I am satisfied that the Scheme will not have a material adverse effect on the financial strength available to support the security of the non-transferring LGI policies.

### The change in the risk profile to which the non-transferring LGI policies will be exposed

- 6.10. Due to the current reinsurance treaty (as described in Section 3), the non-transferring LGI policies are currently exposed to the risks of LGL through the counterparty risk of the non-performance of the contract between LGI and LGL.
- 6.11. As stated above, the transferring business is a small proportion of the total LGI business, and so the effect of the transfer on the risk profile of the remaining LGI business is small.

- 
- 6.12. Both the Pillar I and Pillar II figures, to differing degrees, take account of the company's risk exposures and, based on the figures that I have seen, the transfer has an insignificant effect on both of the Pillar I (2010 year-end) and the Pillar II (2009 year-end) financials. After the Scheme the non-transferring LGI business will be more than adequately capitalised on both a Pillar I and a Pillar II basis.
- 6.13. Therefore, I am satisfied that the Scheme will not have a material adverse effect on the risk exposures of the non-transferring LGI policies.

### **Management and servicing of the non-transferring LGI policies**

- 6.14. The Scheme will lead to no change to:
- The managers or administrators of the non-transferring LGI policies;
  - The terms and conditions of the policies; or
  - The process by which charges to the policies are set.
- 6.15. Therefore, I am satisfied that the Scheme will not lead to any material changes in the management and servicing of the non-transferring LGI policies or to the benefits received under the non-transferring LGI policies.

### **The benefit expectations under the non-transferring LGI policies**

- 6.16. As discussed above, I am satisfied that:
- The transfer will not lead to a material deterioration in the security of the guaranteed benefits under the non-transferring LGI policies;
  - The Scheme will not lead to any change to the administration and service standards received by the non-transferring LGI policies; and
  - The Scheme will not lead to any change to the management or the governance of the non-transferring LGI policies.
- 6.17. Therefore, I am satisfied that the Scheme will not have a material adverse effect on the benefit expectations under the non-transferring policies of LGI.

### **Conclusions for the holders of non-transferring LGI policies**

- 6.18. I am satisfied that the Scheme will not have a material adverse effect on:
- The security of benefits under the non-transferring policies of LGI;
  - The benefit expectations under the non-transferring policies of LGI; or
  - The service standards, management and governance received by the non-transferring policies of LGI.

## 7. THE EFFECT OF THE SCHEME ON THE HOLDERS OF CURRENT LGL POLICIES

### Introduction

- 7.1. In this section I consider the effect of the Scheme on the holders of current LGL policies. As described in Section 3, LGL currently has only long-term policies.
- 7.2. As described in Section 4, under the Scheme, these long-term policies of LGL will remain in LGL and the long-term policies of LGI will be transferred across to LGL. Therefore, the key issues to consider for the current LGL policyholders are:
- The financial strength available to support the LGL policies after the implementation of the Scheme;
  - The changed profile of risks to which the LGL policies will be exposed; and
  - Any changes to the management of the current LGL long-term business.
- 7.3. Currently LGL holds financial resources to cover the reserves and capital requirements in respect of the current LGL policies.

### The financial strength of LGL

- 7.4. Under the Scheme the long-term business of LGL will remain in LGL and the long-term business of LGI will be transferred into LGL.
- 7.5. As described in Section 3, the transferring LGI business is currently reinsured to LGL. The LGL policies are currently exposed to the risks of this transferring business because adverse experience for this block would lead to increased claim payments to LGI under the reinsurance treaty. This exposure is limited to the extent that, in the extreme scenario of LGL's solvency being threatened, the LGL direct business would currently rank ahead of the reinsured LGI business as creditors of LGL.
- 7.6. The Scheme will lead to a deterioration in the financial support available for the current LGL policies as, after the Scheme, there will be an increased number of policies that would, in the event of LGL's solvency becoming threatened, rank equally in terms of a claim on the financial resources of LGL.
- 7.7. The tables in Appendix 1 show that, as at the end of 2010, LGL had total long-term Pillar I policy reserves of £18.0 million covering both its direct written policies and those reinsured in from LGI. Thus, prior to the Scheme, the current direct policies of LGL (with statutory liabilities as at the end of 2010 of £13.8 million) will derive support and security from the excess assets of £12.0 million and will have first claim on these excess assets ahead of the reinsured (from LGI) policies (statutory liabilities as at the end of 2010 of £4.2 million).
- 7.8. After the Scheme, these same excess assets of £12.0 million will provide support and security for the current LGL policies and the transferred in LGI policies (total year-end 2010 statutory liabilities of £18.0 million).
- 7.9. The loss of priority access to the LGL capital (as a result of the Scheme) could only be of material detriment to the security of the benefits under the LGL policies in the case where there is a realistic chance of the post-transfer LGL requiring external capital support. However, in respect of the post-transfer LGL:
- Excess assets of 53% of total statutory liabilities (Table 3 in Appendix 2), together with coverage for the post-Scheme CRR of 191%, are signs of financial strength;
  - The LGL business is fairly stable and has in the past generated healthy surpluses, and is expected to continue to generate surpluses in the future.
- 7.10. Overall I am satisfied that the probability of the LGL policies requiring external capital support is sufficiently remote that the loss of priority access to capital will not lead to a material adverse effect on the security of benefits under the current LGL policies.

- 7.11. The future financial strength providing security for the LGL policies will depend upon the capital management policy of LGL.
- 7.12. The current capital policy has been discussed with the FSA and the Scheme will not change the current capital policy. I am therefore satisfied that the Scheme will not affect the security afforded LGL policyholders by the capital management policy.
- 7.13. I am satisfied that the Scheme will not have a material adverse effect on the financial strength available to support the security of the current LGL policies.

#### **The change in the risk profile to which the current LGL policies will be exposed**

- 7.14. The transfer of the LGL long-term business into LGL changes its status such that, after the Effective Date, this transferred in business will rank equally with the direct LGL business as a creditor of LGL. This directly exposes the existing LGL business to the risks associated with the currently reinsured business and therefore will change the risk profile of the current LGL policyholders.
- 7.15. Although there are some differences between the transferring LGL business and the existing LGL business due to the different demographics of the underlying policyholders, in most respects the transferring LGL business is similar to the existing LGL business as it consists of:
- Long-term business (i.e. terms of 5 years or more);
  - Cover associated with payment protection policies; and
  - Critical illness, accident and sickness policies.
- 7.16. It is therefore likely that the business being transferred in under the Scheme has a similar risk profile to that of the existing LGL business and that therefore the risk exposures of the existing LGL business are unlikely to change significantly as a result of the Scheme.
- 7.17. Both the Pillar I and Pillar II figures, to differing degrees, take account of the company's risk exposures. The Pillar I figures portray the coverage for the security of the guaranteed benefits and the Pillar II figures portray the company's ability to withstand extreme events. Based on projected figures, after the Scheme LGL will be more than adequately capitalised on both a Pillar I and a Pillar II basis.
- 7.18. Therefore, I am satisfied that the change in the risk exposures for the LGL business will not have a material adverse effect on the security of the benefits under the existing LGL policies.

#### **Management and servicing of the current LGL policies**

- 7.19. The Scheme will lead to no change to:
- The managers or administrators of the current LGL policies;
  - The terms and conditions of the policies; or
  - The process by which charges to the policies are set.
- 7.20. Therefore, I am satisfied that the Scheme will lead to no material changes in the management of the current LGL policies or to the benefits received by the current LGL policyholders.

#### **The benefit expectations under the current LGL policies**

- 7.21. As discussed above, I am satisfied that:
- The transfer will not lead to a material deterioration in the security of the guaranteed benefits under the current LGL policies;

- The Scheme will lead to no change to the administration and service standards received by the current LGL policies; and
- The Scheme will not lead to any change to the management or the governance of the current LGL policies.

7.22. Therefore, I am satisfied that the Scheme will not have a material adverse effect on the benefit expectations under the current policies of LGL.

#### **Conclusions for the holders of current LGL policies**

7.23. I am satisfied that the Scheme will not have a material adverse effect on:

- The security of benefits under the current policies of LGL;
- The benefit expectations under the current policies of LGL; or
- The service standards, management and governance received by the current policies of LGL.

## 8. OTHER CONSIDERATIONS DUE TO THE SCHEME

### Solvency II

- 8.1. LGI and LGL are part of the same group and share a considerable number of people and resources. In particular, they share senior actuarial resources (including the AFH) and senior management, and the Boards of the two companies are the same. There is a steering group responsible for the implementation of Solvency II which reports to both the LGI Board and the LGL Board. Therefore, the preparations for Solvency II have been carried out in parallel for the two companies and, in particular:
- LGI and LGL both completed the QIS 5 exercise during 2010;
  - LGI and LGL share the same Solvency II implementation and project plans;
  - The number and calibre of staff currently involved in Solvency II preparations is the same for both companies; and
  - There is equal engagement of the Boards of LGI and LGL with the Solvency II process
- 8.2. LGI and LGL are both applying for approval from the FSA to be able to use a partial internal model in the calculation of their Solvency II capital requirements in respect of non-life underwriting risk (LGI only) and operational risk (LGI and LGL). Both companies have been accepted into the internal model pre-application process by the FSA and are currently completing the self-assessment of their partial internal models in accordance with FSA guidelines. As long-term insurance business, the solvency capital requirements (with the exception of those due to operational risk) in respect of the transferring policies will be calculated using the standard formula.
- 8.3. Under the standard formula, LGI is shown as under-capitalised due to the inadmissibility of certain preference shares. Various actions are currently being considered to remedy this for LGI and this capital shortfall will be addressed whether or not the Scheme is implemented. On the QIS 5 basis, LGL has sufficient capital on a Solvency II basis.
- 8.4. Other than the restructuring of the preference shares, I am not aware of any proposals for restructuring of the business or for any acquisitions or disposals in connection with Solvency II.
- 8.5. Therefore, in my view, it is unlikely that the transfer will have any impact on the Solvency II implementation, project plans or compliance for either of LGI or LGL and I am satisfied that the transfer will not have a material adverse effect on the risks to LGI and LGL from Solvency II.

### The FSA waiver re communications to policyholders

- 8.6. LGI and LGL have applied to the FSA for 'waivers' from the FSA rules regarding policyholder communications during a Part VII transfer. In particular, LGI and LGL have applied for a waiver from the requirement to write to all of the LGI and LGL policyholders.
- 8.7. For the reasons given in Sections 6 and 7 of this report, I am satisfied that the Scheme will not have a material adverse effect on the non-transferring policyholders of LGI and the current policyholders of LGL. I have also discussed with the companies the significant costs that would be incurred from mailing all the LGL policyholders and/or all the LGI policyholders. Therefore, I am satisfied that application for this waiver is appropriate and reasonable in the context of the FSA rules.

### Costs of the Scheme

- 8.8. In my view it is appropriate that the costs of the Scheme will not affect policyholders and will be paid by the shareholders of LGI.

### **Mis-selling risk**

- 8.9. Senior management consider that, as business is sold through independent distributors, such as banks and other finance lenders, in the event that mis-selling claims are made in the future, after the Scheme, liability will lie with the company which sold the policy.
- 8.10. I am satisfied that, the Scheme will have no material adverse effect on the rights of policyholders in the event of such mis-selling claims arising in relation to past business practices.

### **Tax**

- 8.11. There is no expectation that the Scheme will lead to a material change in the tax position of the policyholders of LGI or LGL.

## 9. CONCLUSIONS

9.1. I am therefore satisfied that the implementation of the Scheme will not have a material adverse effect on:

- The security of the guaranteed benefits under the policies of LGI and LGL;
- The benefit expectations under the policies of LGI and LGL; or
- The service standards, management and governance received by the LGI and LGL policies.



Oliver Gillespie

20 September 2011

Fellow of the Institute and Faculty of Actuaries

## APPENDIX 1 – SELECTED FINANCIAL INFORMATION AS AT 31<sup>ST</sup> DECEMBER 2010

The figures in the tables below show the financial positions of LGI and LGL respectively as at 31<sup>st</sup> December 2010 taking account of the post-balance sheet events described in Section 2 of this report – the one-off business provision due for LGI and the dividend payment out of LGL. The figures shown take account of the reinsurance treaty between LGI and LGL that came into effect on 24<sup>th</sup> December 2010 and have been taken from the externally audited and Board approved 2010 year end FSA Returns.

### 1. LGI

LGI £'000	31 December 2010	Other than long-term business	Long-term business fund	Total
<b>Assets</b>	Shareholder assets	518,040	1,819	519,859
	Allocated to long-term business	-3,651	3,651	0
	<b>Total assets</b>	<b>514,389</b>	<b>5,470</b>	<b>519,859</b>
<b>Liabilities (net of reinsurance)</b>	Technical provisions	367,676	150	367,826
	Other	*56,141	1,320	*57,461
	<b>Total liabilities</b>	<b>423,817</b>	<b>1,470</b>	<b>425,287</b>
<b>Excess Assets</b>		90,572	4,000	94,572
<b>CRR</b>		31,144	3,040	34,184
<b>Excess Assets after CRR</b>		59,428	960	60,388

\* 2010 year end number plus £3.1 million one-off business provision included since the 2010 year end.

### 2. LGL

LGL £'000	31 December 2010	Long-term business fund	Shareholders' Fund	Total
<b>Assets</b>		22,476	**12,014	**34,490
<b>Liabilities (net of reinsurance)</b>	Technical provisions	18,031	0	18,031
	Other	3,304	1,185	4,489
	<b>Total liabilities</b>	<b>21,335</b>	<b>1,185</b>	<b>22,520</b>
<b>Excess Assets</b>		1,141	10,829	11,970
<b>CRR</b>				6,276
<b>Excess Assets after CRR</b>				5,694

\*\* 2010 year end number minus £5 million due to be paid out of LGL as a dividend.

### 3. Pillar I solvency ratios for LGI and LGL prior to the transfer

31 December 2010		LGI	LGL
<b>Assets</b>		<b>519,859</b>	<b>34,490</b>
<b>Liabilities</b>	Technical provisions	367,826	18,031
	Other liabilities	57,461	4,489
	<b>Total</b>	<b>425,287</b>	<b>22,520</b>
<b>Excess Assets</b>		<b>94,572</b>	<b>11,970</b>
<b>Pillar I excess assets as percentage of total liabilities</b>		<b>22%</b>	<b>53%</b>
<b>CRR</b>		<b>34,184</b>	<b>6,276</b>
<b>Ratio of excess assets over CRR</b>		<b>277%</b>	<b>191%</b>

## APPENDIX 2 – PRO FORMA FINANCIAL POSITION POST-TRANSFER AS AT 31<sup>ST</sup> DECEMBER 2010

The figures in the tables below show the financial positions of LGI and LGL respectively as at 31<sup>st</sup> December 2010 assuming the transfer had taken place on this date. As with the financials in Appendix 1 these figures take account of the post balance sheet events described in Section 2 of this report – the one-off business provision due for LGI and the dividend payment out of LGL. The figures shown take account of the reinsurance treaty between LGI and LGL that came into effect on 24<sup>th</sup> December 2010 and have been taken from the externally audited and Board approved 2010 year end FSA Returns.

### 1. LGI

LGI £'000	31 December 2010	Other than long-term business
<b>Assets</b>		519,859
<b>Liabilities (net of reinsurance)</b>	Technical provisions	367,676
Net of reinsurance	Other	57,461
	<b>Total liabilities</b>	<b>425,137</b>
<b>Excess Assets</b>		94,722
<b>CRR</b>		31,144
<b>Excess Assets after CRR</b>		63,578

### 2. LGL

LGL £'000	31 December 2010	Long-term Fund	Shareholders' Fund	Total
<b>Assets</b>		22,476	12,014	34,490
<b>Liabilities (net of reinsurance)</b>	Technical provisions	18,031	0	18,031
	Other	3,304	1,185	4,489
	<b>Total liabilities</b>	<b>21,335</b>	<b>1,185</b>	<b>22,520</b>
<b>Excess Assets</b>		1,141	10,829	11,970
<b>CRR</b>				6,276
<b>Excess Assets after CRR</b>				5,694

## 3. Pillar I solvency ratios for LGI and LGL after the transfer

31 December 2010		LGI	LGL
<b>Assets</b>		<b>519,859</b>	<b>34,490</b>
<b>Liabilities</b>	Technical provisions	367,676	18,031
	Other liabilities	57,461	4,489
	<b>Total</b>	<b>425,137</b>	<b>22,520</b>
<b>Excess Assets</b>		<b>94,722</b>	<b>11,970</b>
<b>Pillar I excess assets as percentage of total liabilities</b>		<b>22%</b>	<b>53%</b>
<b>CRR</b>		<b>31,144</b>	<b>6,276</b>
<b>Ratio of excess assets over CRR</b>		<b>304%</b>	<b>191%</b>

## APPENDIX 3 – KEY SOURCES OF DATA

In writing this report, I relied upon the accuracy of certain documents and spreadsheets provided by LGI and LGL. These included, but were not limited to the following:

Description
<b>The Scheme</b>
Scheme document
Witness statement of Kevin Kennedy
<b>LGI</b>
LGI FSA Return 2010
LGI FSA Return 2009
LGI Annual Report 2008
LGI ICA as at 31 <sup>st</sup> December 2008
LGI Pillar II position as at 31 December 2009
QIS5 Summary for LGI
<b>LGL</b>
LGL FSA Return 2010
LGL FSA Return 2009
LGL Annual Report 2008
LGL ICA as at 31 <sup>st</sup> December 2008
LGL Pillar II position as at 31 December 2009
QIS5 Summary for LGL
LGL projected UK GAAP surpluses

## APPENDIX 4 – TERMS OF REFERENCE

The following forms Schedule 2 of my terms of engagement with LGL and LGI.

### **Scope of the work of the Independent Expert in relation to the Scheme**

My report is to consider the terms of the Scheme generally and the effect which the Scheme will have on the Companies' different groups of policyholders.

In particular my report will consider the following specific matters:

- The impact of the Scheme on the security of benefits and the risks policyholders will be exposed to as a result of the transfer;
- How the application of any management discretion that is embedded in the current policies would be affected by the transfer; and,
- The impact of the Scheme on existing service levels and agreements.

The review and report will address generally the way in which the Companies have conducted its long-term business but taking into account the particular circumstances of each class of insurance business to be transferred. It will deal inter alia with the following aspects of the Companies:

- Memorandum, and the Articles of Association, at least insofar as these affect the rights, expectations and interests of policyholders;
- Reserving, capital and security;
- The terms of the policies issued by the Companies;
- The Companies' reinsurance agreements;
- Any service, or other relevant, agreements with intra-group companies;
- The existing and proposed internal working arrangements relating to the financial management of the long-term business fund, including the operational and administrative arrangements which will apply to the business to be transferred under the terms of the insurance scheme;
- Promotional or marketing materials (including those documents issued under the Financial Services and Markets Act 2000 and previous compliance regimes) which would influence the reasonable expectations of policyholders
- The terms and conditions expected to be imposed by the Scheme to be presented to the Court, including the views expressed by the governing body or management of the Companies; and,
- The terms of any previous Schemes of transfer concerning the policyholders of the Companies.

The above list is not intended to be exclusive to any other aspects which may be identified during the completion of the project and which are considered to be relevant.

I shall not be directly involved in the formulation of the proposed transfer although I should expect to give guidance during the evolution of the detailed proposals on those issues which concern me, or which I consider unsatisfactory.

## APPENDIX 5 – STATEMENT OF INDEPENDENCE

### Statement of independence for Oliver Gillespie

#### Introduction

London General Life Company Limited (“LGL”), London General Insurance Company Limited (“LGI”), and TWG Services Limited (together “the Companies”) have proposed me to act as the Independent Expert in respect of a proposed scheme under Part VII of the Financial Services and Markets Act 2000 to transfer the long-term business of LGI to LGL.

I am a Principal of Milliman Limited and I am based in its UK Life Insurance practice in London. I am a Fellow of the Institute and Faculty of Actuaries which was established in 2010 by the merger of the Institute of Actuaries and the Faculty of Actuaries. I became a Fellow of the Institute of Actuaries in 1999.

I am not a shareholder in any of the Companies or their subsidiaries.

I hold no individual policies with any of the Companies or their subsidiaries.

#### Previous work with the Companies

I held the position of Actuarial Function Holder for LGL for the period up to the 2007 year end. Since then I have carried out no work for the Companies.

I have never been engaged by, or carried out any work for, LGI and therefore have never carried out any work concerning, had any oversight of, or any responsibility for, any aspect of the transferring policies.

Milliman has carried out small assignments in relation to Solvency II during 2010 for LGL.

In the period 2007 to 2010, the total work carried out for the Companies by Milliman represented less than 0.5% of Milliman’s revenue in the UK.

#### My independence

Milliman has strict rules around confidentiality and data control. Milliman staff who have provided assistance with Solvency II earlier in 2010 will not:

- Work with or for me on this independent expert assignment;
- Have access to any of my working papers or analysis; or
- Be permitted to talk with my team about any aspect of the assignment or any other assignment relating to the Companies.

The fees since the start of 2007 are of minimal financial relevance to me and to the UK Life practice and so will have no effect on my work.

When considering the potential effects of the Scheme on the security of policyholder benefits, policyholder expectations regarding returns, and the fair treatment of policyholders, the 2007 year end valuation is unlikely to be particularly relevant.

Neither I nor Milliman has had any involvement in the production or review of the 2008/2009 FSA Returns, Report and Accounts, actuarial valuation or ICA numbers on which analysis of the Scheme will be based.

I do not believe that any of the above adversely affects my ability to act independently in my assessment of the Scheme.

Oliver Gillespie

17<sup>th</sup> August 2010

Fellow of the Institute and Faculty of Actuaries

---

## APPENDIX 6 – FSMA 2000 (REGULATED ACTIVITIES) ORDER 2001 – SELECTED PARAGRAPHS

### SCHEDULE 1:           CONTRACTS OF INSURANCE

#### PART I:                CONTRACTS OF GENERAL INSURANCE

##### Accident

1. Contracts of insurance providing fixed pecuniary benefits or benefits in the nature of indemnity (or a combination of both) against risks of the person insured or, in the case of a contract made by virtue of section 140, 140A or 140B of the Local Government Act 1972 (or, in Scotland, section 86(1) of the Local Government (Scotland) Act 1973), a person for whose benefit the contract is made:

- (a) sustaining injury as the result of an accident or of an accident of a specified class; or
- (b) dying as a result of an accident or of an accident of a specified class; or
- (c) becoming incapacitated in consequence of disease or of disease of a specified class,

including contracts relating to industrial injury and occupational disease but excluding contracts falling within paragraph 2 of Part I of, or paragraph IV of Part II of, this Schedule.

##### Sickness

2. Contracts of insurance providing fixed pecuniary benefits or benefits in the nature of indemnity (or a combination of both) against risks of loss to the persons insured attributable to sickness or infirmity but excluding contracts falling within paragraph IV of Part II of this Schedule.

#### PART II:               CONTRACTS OF LONG-TERM INSURANCE

##### Permanent health

IV. Contracts of insurance providing specified benefits against risks of persons becoming incapacitated in consequence of sustaining injury as a result of an accident or of an accident of a specified class or of sickness or infirmity, being contracts that—

- (a) are expressed to be in effect for a period of not less than five years, or until the normal retirement age for the persons concerned, or without limit of time; and
- (b) either are not expressed to be terminable by the insurer, or are expressed to be so terminable only in special circumstances mentioned in the contract.